INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D64/96

Profits tax – capital gains or trading profit – purchased property for user which would amount to breach of lease conditions.

Panel: Audrey Eu Yuet Mee QC (chairman), Brian Hamilton Renwick and Edwin Wong.

Date of hearing: 22 October 1996.
Date of decision: 14 November 1996.

Appeal allowed.

Cases referred to:

Lionel Simmons Properties Ltd v CIR 53 TC 461
All Best Wishes Ltd v CIR 3 HKTC 750

Jennifer Chan for the Commissioner of Inland Revenue.
Lit Kam Leung David of Messrs David K L Lit and Co for the taxpayer.

Decision:

1. The Taxpayer appeals against the additional profits tax assessments for the years of assessment 1990/91 and 1991/92 and the profits tax assessments for the years of assessment 1992/93 and 1993/94.

2. The issue is whether the gains arising from the Taxpayer's disposal of two properties: Properties A and B in an industrial centre are taxable as trading profit or not taxable as capital gain.

BACKGROUND FACTS

3. The following facts can be gleaned from documents which are not in dispute.

4. The Taxpayer is a limited company incorporated on 3 October 1989. On 15 November 1989, its shares were allotted to 4 shareholders who also became directors. On the same day, one of the 4 shareholders/directors who had earlier signed a sale and purchase agreement to purchase Property A nominated the Taxpayer as the purchaser. The purchase price was $7,701,000.

5. According to the accounts of the Taxpayer, on 3 January 1990, a few months after the purchase, the original 4 directors resigned and transferred all their shares to another 4 persons who also replaced the original 4 directors. One of these latter 4 persons was Mr C.

6. However, the Taxpayer's annual returns made up to 30 June 1993 still showed the original 4 shareholders. Unlike the accounts, the annual return only showed 2 rather than 4 of the new shareholders as replacing the original 4 directors. Mr C was one of the two new directors.

7. On 8 January 1990, Property A was assigned to the Taxpayer. On the same day, Property A was mortgaged to Bank D for a loan of $6,500,000 to be repaid by 120 instalments of $90,459.85 per month.

8. On 12 January 1990, the Taxpayer entered into an agreement to purchase Property B for $5,467,700 and this was assigned to the Taxpayer on 8 February 1990. On the day of the assignment, Property B was mortgaged to Bank E for a loan of $3,600,000 to be repaid by 84 instalments of $63,549.83 per month.

9. The Taxpayer subdivided the Properties and let them to various tenants for rental income. Photographs of the Properties show that they were being used as retail outlets and showrooms. Such user was in contravention of the Conditions of Sale which provided that the lots should only be used for a factory. The Lease Enforcement Unit of the District Lands Office inspected the Properties from time to time. They advised that, subject to certain conditions including payment of premium, it might be possible to regularize selected non-conforming commercial uses within industrial buildings. Application should be made to the Town Planning Board. Meanwhile a forbearance fee was payable on a quarterly basis to stave off lease enforcement actions.

10. The Taxpayer did pay the forbearance fee. It engaged solicitors and a property consultant to advise on modification works, negotiations with the District Land Office and application to the Town Planning Board. Meanwhile, the Taxpayer continued to let the partitioned Properties to various tenants and file tax returns for its rental income.

11. On 14 October 1991, the District Lands Office wrote to the Taxpayer's solicitors confirming that the breach of lease condition in respect of Property B was purged during inspection on 14 October 1991. There is no evidence that the breach in respect of Property A was ever purged.

12. On 8 May 1992, the Taxpayer sold Property A for a consideration of $13,137,000 realising a gain of $4,254,598. On 27 April 1993, the Taxpayer sold Property B for a consideration of $11,750,000 realising a gain of $5,175,472.

13. On 30 June 1993, the Taxpayer paid its shareholders a dividend from the gain on disposal and ceased business thereafter.

THE EVIDENCE

14. The Taxpayer called only one witness Mr C, one of the two directors. He said he was a 25% shareholder and that the shareholding position should be as stated in the accounts.

15. Mr C had been in the garment business for over 20 years. He explained that many of the Hong Kong garment manufacturers had moved to set up factory in the Mainland because of the lower rent and the cheaper labour. However these manufacturers still needed a base and a contact point in Hong Kong. He could see that there was a market in renting out small units to these garment manufacturers. The manufacturers could easily absorb the rent of a small area, they could take orders, gather together and communicate with each other. He and three other friends got together and contributed towards the purchase of Property A by taking over the shares in the Taxpayer. Later the Taxpayer purchased Property B for the same purpose. Mr C's own business was also occupying part of the Properties.

16. He claimed that at the time of the purchase, he was not aware that the intended user would amount to non-compliance with the lease conditions.

17. He was rather vague in his evidence as to details. He could not recall dates, the amounts he contributed, the cost of the modification work, the name of the architect or surveyor engaged. He could not explain the discrepancy between the annual return and the accounts as to the names of the shareholders or directors.

18. He could not really explain the problem in the non compliance with the lease condition. He said there was no standard for determining compliance or non-compliance. He said showroom or retail user could not exceed 30% but then there was uncertainty as to how to calculate the 30%. He said they tried to follow instructions and modification work was done many times. But it was still unclear what would be acceptable.

19. Finally it was too much trouble, the forbearance fee was escalating beyond expectation, there was no solution in sight and the Taxpayer sold the two Properties at no loss.

20. It was pointed out to him that the breach in respect of Property B was purged in October 1991. Thus the Taxpayer could have kept Property B and only sold Property A. He pointed out that this did not mean that a similar problem would not recur in future. Any change in the partition or display or arrangement could, on subsequent inspection, said to result in non-compliance.

THE REVENUE'S CASE

21. The Revenue made the following points:

(a) There was no feasibility study or long term plan.

(b) The Taxpayer was aware that the Properties had to be used for factory purposes. It is incredible that, having been in the garment business for some 20 years, Mr C was not aware that the contemplated user would be in breach of lease conditions.

(c) If the Taxpayer had intended to let the Properties out for retail or showroom purposes, they should have obtained a change to the lease condition before leasing to tenants for the non-conforming use. Without obtaining a change to the lease conditions, the intended user was unrealistic because sooner or later the user would have to be terminated.

(d) The Taxpayer only tried to obtain a change to the lease condition when the Lease Enforcement Section of the District Land Office required the Taxpayer to remedy the breach.

(e) The Taxpayer should have a long term plan as to how to meet the forbearance fee.

(f) All lettings were only for short terms. What the Taxpayer was doing was part of a short term measure to wait for the appropriate time to sell.

(g) The indebtedness namely the bank mortgage and the directors' loans were classified as current liabilities rather than long term liabilities.

(h) Immediately after the sale, the Taxpayer distributed the proceeds and ceased business.

THE LAW

22. The law in this matter is well settled. The usual cases were cited: Lionel Simmons Properties Ltd v CIR 53 TC 461 and All Best Wishes Ltd v CIR 3 HKTC 750. The onus is on the Taxpayer to persuade us that the intention was to acquire the Properties as an investment rather than for disposal at a profit.

REASONS FOR DECISION

23. A preliminary point is Mr C's authority to speak on behalf of the Taxpayer. There are two matters for consideration. First, it is said his name does not appear as a shareholder. Secondly, he could not speak to the intention of the 4 directors who purchased Property A prior to his purchase of the shares.

24. The first point is not a matter of concern. Mr C is one of the directors. The Taxpayer is represented at the hearing by its accountant. They clearly have the authority to represent the Taxpayer. Further, Mr C signed all the Taxpayer's accounts. He pointed out that the banks would not have agreed to lend on the guarantees of himself and his three

friends if their ownership of the shares was in question. It is not our concern whether or not their shareholding is properly reflected in the annual returns filed.

25. The second point can also be resolved. The Taxpayer's intention depended on the intention of its directors. We have not heard from the original 4 directors. However intention can change. What was first an investment may be put into trading stock and vice versa per Lord Wilberforce Lionel Simmons Properties Ltd v CIR 53 TC 461 at page 491. Thus Mr C is able to tell us the Taxpayer's intention in respect of the Properties as at January 1990 when Mr C and his friends took over. That would be the relevant intention for determining the Taxpayer's liability or otherwise for profits tax on the gains realized upon subsequent disposal of the Properties.

26. We are not at all surprised that there was no feasibility study or written plan. Often there is none. Mr C (and no doubt his friends in the garment business) did not look like the sort of persons who would prepare written feasibility studies. If any contemporaneous written evidence is needed, it can be seen in the Taxpayer's accounts that its principal activity was investment in immovable property for rental income.

27. For the same reason, no adverse inference can be drawn from the fact that in the same accounts, the directors' loans and bank mortgages were described as 'current liabilities' rather than 'long term liabilities'. When the question was put to Mr C, he could hardly understand the distinction. He relied on the accountant for the use of accounting terms. In contrast, the Properties were described as 'fixed assets' rather than 'stock'. We do not place much reliance on these descriptions.

28. We accept Mr C's evidence that he and his friends intended to acquire the Properties for rental in smaller units to garment manufacturers who needed a base in Hong Kong. We agree with the Revenue that they must have known that such user would contravene the lease conditions. Equally they must have known that such user would be tolerated on payment of forbearance fee and modification may be obtained on payment of premium and other conditions.

29. They saw there was a good market for the sub-divided units and they were proved right. The combined monthly mortgage was about $163,000. The monthly rental was about $200,000. In the first year, there was a net profit of $436,480.97. This was after payment of all expenses including $87,198 Government forbearance fee and $1,792,657.20 'leasehold improvement' which might have included cost of the modification works. In the second year, the net profit went up to $580,863.68. This was after payment of $948,400 Government forbearance fee. By then the forbearance fee was as much as 30% of the rental income for the year.

30. The Taxpayer would probably have gone on making a profit from the rental if there was a solution to the non compliance problem. The threat of Lease Enforcement Action and the repeated visits by the lease enforcement unit must have made the Properties less attractive to potential tenants. The escalation of the forbearance fee can be seen from the figures in the previous paragraph. More importantly, there was no way to predict or

make provision for the forbearance fee which was chargeable quarterly and notified from time to time. It is difficult to see how the Taxpayer could have made provisions for it.

31. The Taxpayer instructed a solicitors firm to negotiate with the District Lands Office and the solicitor in turn instructed a firm of property consultants to advise and make the necessary application to the Town Planning Board. According to the District Land Office's letter dated 30 September 1996, the Town Planning Board had disapproved the Taxpayer's application for review in respect of Property A. There is no evidence that any similar application in respect of Property B was successful. The District Land Office's letter dated 24 October 1991 said that a follow-up inspection on 14 October 1991 on Property B by officers from the Lease Enforcement Unit revealed that the former breaches had been satisfactorily purged. The letter concluded by saying that, should the breach occur again, the Government would take a more serious view. We agree with Mr C that this letter did not mean that the problem was solved. With the intended user, there was every possibility of further breaches in future. Having tried for some time, no solution was in sight. In the circumstances, when the price was good, it is hardly surprising that the Taxpayer sold the Properties.

32. The Revenue criticized the Taxpayer's plan as unrealistic. It is said that if they had truly intended to hold the Properties for long term investment, they should have applied for a change to the lease conditions earlier, made provisions for the forbearance fee and anticipated the difficulties. However the Taxpayer's conduct may equally be explained by lack of thorough planning or insufficient apprehension of the magnitude of the problem.

33. Action often speaks louder than words. The Taxpayer's subsequent conduct testify to their intentions. After the purchase, the Taxpayer divided the Properties for rental, spending some $1,792,657.20 on leasehold improvements. They stuck at that for two years. Meanwhile they incurred all the costs and went through the trouble of engaging solicitors and a property consultant for the necessary advice and actions. We also bear in mind that the director's loan was some $4,000,000. The monthly mortgage payment of $163,000 was not insignificant. Yet the Taxpayer held Property A for some 2 years and Property B for some 3 years. Mr C knew the garment business. He had need of the Properties and also knew other garment manufacturers had a similar need. It is wholly understandable why they decided to invest in the Properties for the reasons given. We do not believe that he and his friends would purchase these Properties and did all that they did if they were merely intending to trade in industrial properties for a profit. We also find that since the original intention of letting the Properties to the garment manufacturers had proved, after some two years, to be unrealistic it is not surprising that the Taxpayer sold the Properties and distributed the proceeds instead of investing in a similar venture.

34. For reasons given, we find the Taxpayer held the Properties as capital and was accordingly not liable for profits tax on the realized gains. The appeal is accordingly allowed.